22047 and 22047-A (Consolidated)

UNITED STATES COURT of APPEALS

FOR THE NINTH CIRCUIT

MELVIN L. HAIR and ESTHER HAIR, his wife,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

AND

RICHARD E. HAIR and NAOMI L. HAIR, his wife,
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vs.

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On Petitions For Review of Decisions of The Tax Court of the United States (Tax Court Nos. 3297-65 and 5001-65)

BRIEF OF PETITIONERS

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OPINION BELOW

The Tax Court opinion filed February 9, 1967 (R. 88), resulting in decisions adverse to petitioners entered April 3, 1967 (R. 105, 107), is not yet officially reported.

JURISDICTION

Petitioners reside in the State of Washington. Their federal income tax returns for the tax years in question (1962 and 1963) were filed with the District Director at Tacoma, Washington. (R. 49-82; joint exhibits 1A, 2B, 3C and 4D)[1] After treasury audits, deficiency notices were issued to the petitioner-taxpayers on March 11, 1965 and May 25, 1965. (R. 1, 17). The deficiencies were protested by petitioners to the extent the Commissioner determined they could not treat their sales of sand and gravel on their 1962 and 1963 returns as capital gain transactions. (R. 4, 20)

Within the time limited, petitioners filed amended petitions with the Tax Court for redeterminations of the deficiencies pursuant to 26 U.S.C. Section 6213. (R. 1, 17)

The parties submitted the cases, after consolidation (R. 38) upon joint stipulation of facts (R. 40) and joint exhibits therein referred to, with their briefs. (R. 49-87)

The Tax Court opinion (R. 88-98) upholding the respondent Commissioner was followed by decisions entered April 3, 1967 (R. 105, 107). The cases were brought to this Court within the three months period prescribed by Section 7483 of Internal Revenue Code of 1954 by petitions for review filed June 19, 1967. (R. 108, 121) Jurisdiction of this Court is conferred by Section 7482 of that Code. (26 U.S.C. 7482, 7483)

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(1) See Appendix of Exhibits post p. 39

This Court ordered consolidation of the petitions for review for appeal purposes on August 4, 1967. (R. 38)

ISSUES PRESENTED

1. When petitioners, whose sole business is farming, who never engaged in the sale of sand and gravel, in the ordinary course of business, obligated a single purchaser to purchase and remove "all of Sellers' right, title and interest in and to the sand and/or gravel situate upon . . ." specified acres of their large grain farm, within three years, the time estimated as sufficient to enable the purchaser to remove a total volume of the materials sufficient to enable the purchaser to fulfill his federal dam construction contract, at a fixed price per cubic yard, payable every thirty days as removed, did the petitioners reserve or retain any such "economic interest" in the sand and gravel (except for security purposes) as to preclude them from the benefit of the capital gains tax provisions of the Internal Revenue Code? (26 U.S.C., Section 1201-1244, particularly Section 1221; R. 40-48).

2. Did the Tax Court erroneously hold that the written agreement (Joint Ex. No. 6F; R. 84-87) when read with the Stipulation of Facts (R. 40) and joint exhibits referred to therein (R. 49-87), was intended to be a mineral lease or royalty or mere license agreement to remove sand and gravel and not, a contract of sale of capital assets in specified volume over a fixed period of time, with a definite obligation on the part of both sellers and purchaser to so perform the contract? (R. 88-98).

3. Did the Tax Court err in determining that when the purchaser ceased to remove sand and gravel from petitioners' land after the purchaser had completely performed his sub-contract at Lower Monumental Dam, that an "economic interest" reverted to petitioners? (Joint Ex. No. 6F) (R. 84-87).

STATUTES INVOLVED

Internal Revenue Code of 1954, as amended (26 U.S.C. 1201-1244), particularly see 26 U.S.C., p. 71:

> "Section 1221. Capital Asset Defined for purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
>
> (3) a copyright, a literary, musical, or artistic composition, or similar property, held by—
>
> (A) a taxpayer whose personal efforts created such property, or
>
> (B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1961, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

26 U.S.C. (1967 ed.,) Section 1221, p. 71.

STATEMENT

The Tax Court held that revenue from the sale of sand and gravel from petitioners' farmlands was not a capital gain and that the transaction gave rise to ordinary income within the meaning of the federal income tax law.

The facts must be adduced solely from the stipulation of facts and joint exhibits, including particularly, Ex. 6F, the contract of sale. (R. 40 at 48; R. 84-87) Questions of mixed fact and law arise in these cases by reason of the differing interpretations of the contract and surrounding circumstances, by the Commissioner, the Tax Court and petitioners. Therefore, we incorporate by reference the stipulation of facts and joint exhibits 1A through 6F as a part of this brief. (R. 40-48; 49-87). Exhibits 1A, 2B, 3C and 4D are the 1962 and 1963 income tax returns of the respective petitioners, Melvin L. Hair and Esther Hair, Richard E. Hair and Naomi L. Hair. Exhibit 5E is a map descriptive of the farmlands of petitioners, showing red

shaded areas where the gravel was located before removal; also demonstrating the proximity of the sand and gravel bed to the damsite on the Snake River where the purchaser had formally subcontracted to make use of the purchased materials. (See R. 83)

Exhibit 6F, the contract authorizing removal of the sand and gravel, (R. 84-87) is couched in sales language. The contract must be interpreted "from its four corners" — significant portions of the contract include the following:

> "That in consideration of the sum of Ten Dollars ($10.00), receipt of which is hereby acknowledged, and of the stipulations herein contained, and the payments to be made as hereinafter specified, the Seller hereby agrees to sell to the Purchaser, and the Purchaser hereby agrees to purchase from the Seller, the following:
>
> > All of Sellers' right, title and interest in and to the sand and/or gravel situate upon the following described premises:
> >
> > All of Section Eleven (11) and the South Half of the Southwest Quarter and the Southeast Quarter of Section Two (2) in Township Twelve (12) North, Range Thirty-four (34) E.W.M., Walla Walla County, State of Washington.
>
> This agreement shall remain in full force and effect for such a time as shall be required to enable Purchaser to complete its contract with the Prime Contractor related to construction of Lower Monumental Dam on the Snake River under which contract Purchaser has agreed to furnish all sand and gravel for construction of the south shore portion of said Dam. It is estimated that per-

formance of the said contract by Purchaser shall take approximately three (3) years from the date of this Agreement but that Purchaser shall, nevertheless, have the full time necessary to complete said contract. In the event of the abandonment of said contract by Purchaser, this contract shall be deemed terminated. . . ." [2]

The purchaser agreed in the contract to pay the Seller Fifteen Cents (15c) per cubic yard for all sand and gravel removed from the lands of the Seller. (R. 85) Payments were contracted by the purchaser to be made once a month based on statements furnished to petitioners and on records kept at Lower Monumental Dam site for all materials removed during the previous calendar month.

The parties provided for arbitration of disputes as to amounts of sand and gravel removed by the purchaser from petitioners' lands. (R. 85)

The contract required written consent from the sellers before sand or gravel could be removed from any of the lands which were summerfallowed or cultivated. (R. 86)

The Stipulation of Facts (R. 40-48) agreed to between the parties provided:

(a) That the 1962 and 1963 returns were timely filed with the proper District Director;

(b) That deficiency notices when received resulted

(2) The contract was not "abandoned" in a realistic sense but was terminated by mid 1964 when the purchaser's subcontract at Lower Monumental Dam was completely performed. (R. 41-42)

in timely filing of petitions to the Tax Court; (R. 40-41)

(c) That petitioner husbands are owners of undivided one-half interests in the farmlands shown on the map, Exhibit 5-E, through the Estate of their late mother;

(d) That Curtis Construction Company, a subcontractor at Lower Monumental Dam on the Snake River, State of Washington, needed sand and gravel to fulfill its subcontract for materials it was obliged to deliver for use at the dam site; that its borings located suitable sand and gravel on petitioners' farmlands of commercial value;

(e) That upon fulfillment of its subcontract on the Lower Monumental Dam federal construction contract in 1964, uninfluenced by petitioners, the purchaser of the sand and gravel voluntarily abandoned or terminated its contract with petitioners; (R. 42)

(f) That Curtis had purchased the right to remove "all the commercially valuable sand and gravel on said lands of petitioners," under the contract, Exhibit 6F; (R. 42)

(g) That during 1962, 1963 and a portion of 1964, Curtis removed sand and gravel pursuant to the contract, Exhibit 6F, and paid for the same in accordance with the terms of that contract; (R. 43)

(h) That the sand and gravel so purchased and re-

moved was paid for at a fixed price per cubic yard in monthly installments as required by the contract which "expressed the meeting of the minds of the parties". It provided interalia that the Curtis Construction Company agreed to purchase:

> "All of the sellers' right, title and interest in and to the sand and/or gravel situate . . . " upon the specified lands of petitioners and also deemed the contract terminated "In the event of abandonment of said contract by purchaser . . .". (R. 43)

(i) Curtis commenced removal of the materials in 1962. The parties deemed the contract terminated in 1964,[3] when Curtis completed its subcontract; (R. 44)

(j) That the Purchaser on its income tax returns gave certain tax treatment to its transactions under the contract (Ex. 6F) satisfactory to the Commissioner, to which statement of fact petitioners objected as to materiality and relevancy; (R. 44, 48 par. 14)

(k) That petitioners were the actual sellers and that they were of the view the payments received pursuant to Exhibit 6F "were payments received in return for the sale of the sand and gravel in place. Accordingly, they reported the payments as the sales price of a capital asset held over six months." (R. 45)

(1) That at all times relevant petitioners were farmers, never engaged in the trade or business of selling or marketing sand and gravel; that the land described on Exhibit 6F was part of their farmlands, the greater portion of which was wasteland, the situs

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(3) These cases will in effect also determine the legal status of tax deficiencies claimed with relation to petitioners' 1964 returns.

of a known deposit of sand and gravel; that a supplemental written agreement would be required before the purchaser might remove sand and gravel from cultivated portions of the land; that Curtis did not have occasion to remove sand or gravel from the cultivated or summerfallow lands, except in amounts de minimus; (R. 45)

(m) That certain adjustments, not herein directly in issue, would be made in the 1962 and 1963 returns, depending on the outcome of the cases; (R. 46, 47)

(n) That in "simplest form, the issue . . . is whether the money received . . . was long term capital gain or ordinary income." If ordinary income, depletion allowance of five percent is allowable. If capital gain was realized, no depletion allowances should be made.

The Stipulation of Facts and joint exhibits constitute the entire record from which the facts and law must be deduced by inferences and interpretation.

The opinion of the Tax Court (R. 88-98) is sufficient to constitute findings of fact and conclusions of law. Cf. **Stone v. Farnell** (CA 9) 239 F. 2d 750 (1956).

SPECIFICATIONS OF ERROR

The Specifications of Error are the same in each case. The specifications will encompass the Statement of Points filed herein pursuant to Rule 17(6) CA 9. (R. 134)

The Tax Court erred:

(1) In refusing to hold that when petitioners, who

are farmers, not engaged in the sale of sand and gravel in the ordinary course of business, sold sand and gravel in place on the uncultivated or wasteland portions of their grain producing farm, the purchase price paid constituted capital gains from the sale of capital assets as defined by 26 U.S.C. Sections 1201-1238, particularly Section 1221.

(2) In its interpretation of the contract (Joint Exhibit No. 6F, R. 40) by finding no present sale thereunder to the purchaser of all commercially valuable sand and gravel on the described lands of the petitioners in volume necessary to enable purchaser to fulfill its subcontract on the Lower Monumental Dam. (R. 40-42)

(3) In finding that the payment to petitioners by the purchaser for the sand and gravel at the rate of Fifteen Cents (15c) per cubic yard, constituted ordinary income to petitioners and not capital gain, for federal income tax purposes.

(4) In holding the taxpayers retained substantial or material economic interests in the sand and gravel attempted to be sold in place for other than security purposes to insure payment of the purchase price.

(5) In holding the written agreement (Joint Ex. No. 6F, R. 40) was not a sales agreement but was a lease or royalty agreement.

(6) In holding there was no legal obligation on the part of the purchaser to pay for all of the commercially valuable sand and gravel on the 760 acre portion of petitioners' farm wastelands in volume necessary to en-

able the purchaser to fulfill its subcontract at Lower Monumental Dam project. (R. 40-42).

(7) In failing to find the agreed Stipulation of Facts, including Joint Exhibits 1A to 6F, inclusive, in fact and law, was a capital gains transaction and not realization of ordinary income to the petitioners. (R. 40-87)

(8) In holding the petitioners liable to payment of tax deficiencies or penalties on the basis of tax rates related to ordinary income realizations instead of income by way of capital gains from sale of capital assets — sand and gravel.

(9) In refusing to follow rationale of the decisions of the Ninth Circuit, particularly **Gowans v. Commissioner** (CA 9) 246 F. 2d 448, 451, (1957) where a company obligated itself to remove all sand under bona fide contract of sale, was held not a mineral lease or royalty or license agreement.

(10) In its refusal to set aside the tax deficiencies challenged by petitioners related to their 1962 and 1963 income tax returns.

SUMMARY OF ARGUMENT

For brevity and coherence, we will argue the Specifications of Error in mainly three categories. First, we will deal with those related to the contract (Joint Ex. No. 6F; R. 84-87) and second, those posed by the Stipulation of Facts and Joint Exhibits referred to in the Stipulation. Specifications (2), (3), (4), (5), (6) and (9) relate primarily to the contract (Joint Ex.

No. 6F). Specifications (1), (7), (8) and (10) relate more to the Stipulation of Facts and Joint Exhibits referred to therein. (R. 40-48; 49-87) Thirdly, we will deal with the questions of mixed fact and law related to the Record and the Tax Court's opinion for clarification of petitioners' contentions. (R. 88-98)

THE CONTRACT

In substance, the contract (Joint Ex. No. 6F; R. 84) was intended to be and was a contract for sale and removal of sand and gravel in place in volume necessary to permit the purchaser, Curtis Construction Company (hereafter "Curtis"), to perform within three years its subcontract at Lower Monumental Dam site. The contract was in neither form nor substance a lease, royalty agreement, or a license.

The parties are designated as "Seller" and as "Purchaser". The sales price is based upon Fifteen Cents (15c) per cubic yard of material, payable within thirty (30) days following removal.

The purchaser was clearly obligated to remove all the commercially valuable sand and gravel on petitioners' described wastelands needed to fulfill the Curtis subcontract on the dam construction project near petitioners' lands. (Joint Ex. No. 5E) Curtis purchased "all" of the sand and/or gravel on specified lands and contracted to remove it within the three years estimated for completion of the subcontract. That subcontract was performed and all the sand and gravel commercially valuable to Curtis for that subcontract was removed and paid for in 1962, 1963 and

1964 when the contract with petitioners was terminated. The transaction involved the sale of capital assets by sellers to the purchaser under 26 U.S.C. Section 1221. But for Internal Revenue Code Sections 1201-1244, gains from the sale or exchange of capital assets such as sand and gravel would be taxable as ordinary income. Capital gains are gains from the sale or exchange of capital assets. Section 1221 of the Code (See P. Page 4 this Brief) defines certain assets not entitled by law to capital gains income tax treatment. Sand and gravel is not one of the assets so excluded by Section 1221 of the Code.

THE STIPULATION OF FACTS

The Stipulation of Facts confirms that: (a) Curtis "needed sand (and gravel) to fulfill its subcontract" (R. 40); that borings by Curtis revealed "a great quantity of sand, and some gravel" in the area (R. 42); that Curtis under the contract (Ex. 6F) "had purchased the right to remove all commercially valuable sand and gravel on said lands of petitioners . . ." (R. 42); that Curtis in 1962, 1963 and during part of 1964 removed and paid for "the desired sand", "pursuant to the contract" which "expressed the meeting of the minds of the parties" and Curtis "agreed to purchase":

> "All of the sellers' right, title and interest in and to the sand and/or gravel" on the described lands. (R. 43)

The stipulation clearly states that Curtis "voluntarily, by its own unilateral decision, abandoned the contract following fulfillment of its subcontract" on the Lower Monumental Dam project. (R. 42)

The Government agreed that: "Any[4] commercially valuable sand or gravel on said lands of petitioners remaining when Curtis completed his subcontract on the dam was voluntarily abandoned by Curtis by its own decision in 1964, uninfluenced by petitioners." (R. 42) Thus, any so-called "abandonment" took place only after Curtis had removed all the sand and gravel he intended to purchase and was obligated to purchase under terms of the contract with petitioners. The right to take the sand and gravel to fulfill his subcontract for the dam construction project was obligatory upon Curtis.

The provision of the contract (Ex. No. 6F) for termination in the event of abandonment by Curtis was a mere safeguard against breach. Both parties knew and intended to implement the fulfillment of Curtis' formal subcontract and not to confer a mere option to purchase, remove and pay for sand and gravel. The contract was subject to specific performance by both of the parties; by Curtis because he had to have the material in great quantity in proximity to the damsite and by petitioners because they not only wanted to sell their sand and gravel but to level and improve their wastelands with the overburden soils "reasonably leveled off by bulldozer or otherwise" by Curtis. (R. 86)

It was estimated when the contract was delivered to Curtis that all the commercially valuable sand and gravel necessary for fulfillment of the Curtis subcontract would be removed within "approximately three

(4) No stipulation was made there was any commercially valuable sand or gravel left on the described lands when Curtis completed his Government contract.

(3) years from date of this Agreement (April 11, 1962) but that Purchaser shall, nevertheless, have the full time necessary to complete said contract" — (the subcontract at Lower Monumental Dam).

This clearly indicates the obligatory nature of the agreement, Ex. 6F. That contract, confirmed in Curtis, the purchaser, not only the "right" to remove sand and gravel but also all "title and interest in and to the sand and/or gravel" of petitioners as sellers, not as lessors or optioners or licensors. (R. 84)

There was no language in the contract reserving any "right, title or interest" in the commercially valuable sand and gravel unto petitioners. These property rights passed to Curtis when the contract was delivered, subject only to performance of his obligation to remove all the materials needed for performance of his subcontract and pay for the same at the agreed rate of 15c per cubic yard during the time he was performing his subcontract.

Every contract for sale of any form of capital asset reserves protections for the seller as well as the purchaser, including definition of what the consequences of abandonment and breach will be, and means of securing payment of the agreed purchase price.

The Tax Court overlooked the clear intention of the parties to the contract of sale and treated it as a mineral lease or royalty agreement, an over-simplification when petitioners were not engaged in mere exploitation of their sand and gravel.

Petitioners will argue that in fact and law these cases are clearly distinguishable from the cases relied upon by the Tax Court in its opinion. Several cases were misinterpreted by the Tax Court, including **Gowans v. Commissioner**, 246 F. (2d), 448 (C. A. 9, 1957), and **Laudenslager v. Commissioner**, 305 F (2d) 686, (C. A. 3, 1962) Cert. Den. 371 U. S. 947 (1963).

Petitioners reserved no economic interest in the sand and gravel sold and had no right to share in Curtis' earnings or profits under his subcontract on the federal dam project; nor did any economic interest "revert" to petitioners. The purchaser removed and paid for all he needed for performance of his subcontract.

The instant cases are clearly distinguishable, in fact and law from the five mineral lease, royalty or license agreement cases denied certiorari by the United States Supreme Court on December 4, 1967. See pp. 32-35 this Brief.

Petitioners received from Curtis the agreed sales price in installments, not payments out of production as in the lease, royalty and license cases.

THE TAX COURT OPINION
(R. 88-89)

The Tax Court opinion read too much into both the contract of sale (Joint Ex. 6F; R. 84-87) and the Stipulation of Facts. (R. 40-87) It also drew strained inferences therefrom, resulting in clearly erroneous in-

terpretation of the record and construction of the law related to the documents constituting the record.

To illustrate:

(a) While certifying correctly that Curtis removed the sand and gravel in volume necessary to fulfill and perform its subcontract on the dam project as contemplated by terms of the contract, the Tax Court implied that Curtis removed only "quantities of the desired sand . . . "(R. 91)

Actually, Curtis removed and paid for all of the commercially valuable sand and gravel he needed to completely perform the subcontract on the Government dam; not just a portion of the same;

(b) This error was then compounded when the Tax Court inferred that when ". . . Curtis performed its subcontract on the dam project . . ." he "abandoned the instant contract," and that ". . . the agreement was deemed terminated and the right to exploit the unmined sand and gravel reverted to Melvin and Richard . . ." (petitioners).

This is an amazing stretch of the true context of both the agreement (Ex. No. 6F) and the Stipulation of Facts itself which merely contemplated a sale of that specific volume of materials reasonably necessary to enable Curtis to perform his subcontract — the sale of specific and not an undefined volume of the materials. The parties did not estimate when the contract was delivered that there would remain any unmined

commercially valuable sand and gravel on the described wastelands after Curtis had performed his subcontract at the dam. The opinion injects an assumed reversion of unmined sand and gravel to the farmer petitioners when the parties only intended to implement fulfillment of the subcontract by Curtis by obligating him to remove enough material for that performance. (R. 9).

(c) The Tax Court states "as the contract between petitioners and Curtis was not intended to and did not effect an immediate sale of all the sand and gravel in place, it cannot be said that petitioners transferred their entire interest by means of the contract. Instead, they retained an economic interest in the sand and gravel in place . . ." (R. 91-92) The Tax Court overlooked the substance of the contract (Ex. No. 6F).

That contract was designed, as far as was practicable when it was delivered, to sell just enough material to allow fulfillment of Curtis' subcontract. Petitioners sold "all of the sellers' right, title and interest in and to the sand and/or gravel situate . . ." on described waste lands, exclusive of summerfallowed or cultivated portions of the land, in volume, ". . . required to enable Purchaser to complete its contract with the Prime Contractor . . . under which contract Purchaser has agreed to furnish all sand and gravel for construction of the south shore portion of said Dam . . ." (R. 90-91). Petitioners reserved no interest in any of the commercially valuable materials on the described land required by Curtis to perform said subcontract at the Dam. There

was a completed sale, obligating Curtis to remove and pay for all that specified volume of materials within an estimated three years and he performed both the subcontract and petitioners' contract for sale of capital assets.

The supposed reverter of "unmined sand and gravel" assumes facts not in the record nor reasonably to be inferred from the record as made by the parties.

Also, the Tax Court found such assumed "unmined sand and gravel" was "abandoned" to petitioners when, in fact, Curtis admittedly used all the commercially valuable materials on the described land "required to enable Purchaser to complete its contract . . ." (R. 91)

On such an analysis, sand and gravel could not be sold in place by a farmer (or any seller not engaged in sale of sand and gravel in the ordinary course of business), even in specifically described volume without deeding away the land itself.

(d) The Tax Court overlooked the language of the Stipulation of Facts which states: "The Curtis Construction Company voluntarily, by its own unilateral decision, abandoned the contract **following fulfillment of its subcontract** on the Lower Monumental Dam federal construction project . . .". This was the result intended when the contract, (Ex. No. 6F), was delivered, so there was no abandonment — only a **termination** of that contract. (emphasis ours)

The Tax Court read into the word "abandoned" a reverter of "unmined sand and gravel", when it is unrevealed in the Record that there were any commer-

cially valuable materials left on the described portion of petitioners' farmlands.

(e) The Tax Court isolated certain language in the Stipulation of Facts out of context to make a finding of reverter of "unmined sand and gravel" to erroneously establish "economic interest" in petitioners. The Stipulation of Facts (R. 42) admitted that "Any commercially valuable sand or gravel on said lands of petitioners when Curtis Construction Company so determined to stop exploiting said sand and gravel deposit was voluntarily abandoned by Curtis Construction Company by its own decision in 1964, uninfluenced by petitioners." Petitioners did not admit there was, in fact, any commercially valuable material left on their described wastelands. The Tax Court erroneously **assumed** there was. (Emphasis ours)

(f) The Tax Court erroneously failed to read that portion of the Stipulation reading: "It (Curtis) needed sand to fulfill its subcontract" (R. 42) with that portion of the sand and gravel contract, Ex. No. 6F, reading:

"This agreement should remain in full force and effect for such a time as shall be required to enable Purchaser to complete its contract with the Prime Contractor related to construction of Lower Monumental Dam on the Snake River under which contract Purchaser has agreed to furnish all sand and gravel for construction of the south shore portion of said Dam — Purchaser shall, nevertheless, have the full time necessary to complete said contract . . ." (R. 84).

Curtis had a right to all the sand and gravel needed to fulfill the subcontract and title was vested in him to that amount of the sand and gravel in place.

Any other language in the contract (Ex. No. 6F) and Stipulation of Facts not related to this dominant purpose of the sales agreement and the transaction as a whole to implement the performance of Curtis' subcontract by sale of enough sand and gravel to fulfill his commitment at the Dam, should have been considered mere surplusage.

(g) The Tax Court erroneously stated petitioners "retained an economic interest in the sand and gravel in place"; that payments from Curtis were mere compensation for removal of the sand and gravel on an "if and when" basis and, therefore, taxable as ordinary income. (R. 92)

The answer to this is that the contract obligated the petitioners to sell the volume of materials specified, from described lands, at the price stated, and obligated Curtis to remove those materials and pay for them on a per unit basis specified until his subcontract was performed with the Prime Contractor on the Dam project. This both parties did which is the strongest evidence of the intentions of the parties. The Tax Court interpretation rests upon speculative fiction aliunde the expressed intention of the parties to the contract and Stipulation of Facts. The form and substance of the sales contract and circumstances of performance seem to be clear, particularly when Curtis removed no sand

or gravel except for performance of his subcontract at the Dam. He then immediately terminated operations. The Court should not have assumed there remained any more commercially valuable sand or gravel on the tract of wasteland described in Ex. No. 6F.

Contrary to the Tax Court opinion (R. 92), petitioners did transfer all of their commercially valuable sand and gravel in volume necessary to enable Curtis to fulfill his subcontract. Both the sellers and the purchaser believed they had obligated themselves to so sell and purchase, remove and pay for the estimated volume of materials at a price and within the time required for performance of the subcontract. They transferred all "right, title and interest" to that sand and gravel in place. The purpose of the parties to the contract of sale was not to exhaust any "retained interest" as in **Palmer v. Bender**, 287 U.S. 551 (1933) or **Burton-Sutton Oil Co. v. Commissioner**, 328 U.S. 25 (1946) or like cases. (R. 92). Nor did petitioners look solely to the extraction of the sand and gravel for the return of their capital investment in those materials sold under Ex. No. 6F. They looked to the purchase price which Curtis agreed to pay, on a unit basis, under an installment contract of sale, not the mere right of Curtis to extract the sand and gravel on an "as, if and when basis." (R. 93) Curtis was legally bound by contract with petitioners to remove the material.

The Tax Court clearly erred in stating, under circumstances of these cases, that the $10.00 nominal consideration stated in the contract was the sole test of

the intention of the parties not to make a present sale of sand and gravel in place. Also, the Tax Court erred in its statement (R. 94): "Curtis was in no way obligated to remove any of the sand and gravel nor was it, by the terms of the contract, obligated to make any payments (apart from the $10.00 already noted) to the petitioners." This construction of the sale contract stultifies contract law and would preclude a sale or conditional sale of sand and gravel in place. It would forbid an installment contract for sale of materials in place and, as a practical matter, disallow per unit pricing based upon measurement at time of removal. No sand or gravel could be sold in place without subjecting the land owner to taxation at ordinary income rates. This would prohibit one not engaged in the sale of hard minerals in the ordinary course of business from obtaining the benefits of Section 1221 of the Internal Revenue Code. The Tax Court admits: "The duration of Curtis' right to remove the sand and gravel was to be measured solely by the duration of its subcontract on the dam project." (R. 94) However, the Tax Court again erred in stating: "At the termination of their contract, the right to exploit the remaining sand and gravel would revert to the petitioners." (R. 95) This patently overlooks the obligation under the contract (Ex. No. 6F) (R. 84) of petitioners and Curtis to perform by sale and purchase a definitely determinable volume of sand and gravel measured by the volume needed for performance of the subcontract by which Curtis was bound. The Tax Court infers nonperformance was implicit in the contract, Ex. No. 6F. To the contrary, petitioners obligations under the con-

tract were enforceable by suit for specific performance.

The Tax Court bypasses the clear language of Ex. No. 6F which "would appear to call for a present transfer . . ." (R. 95), and states ". . . we are led to conclude that the absence of an obligation, or an intent, to mine to exhaustion and the corresponding lack of a fixed personal liability on the part of Curtis to make further payments reveal that in fact the parties intended that petitioners would not relinquish their entire interest in the sand and gravel in place until actual removal and payment." (R. 95) This ignored the expressed intention to sell the specified volume of sand and gravel in place, not for the mere $10.00 nominal consideration but for fifteen cents (15c) times the cubic yards of sand and gravel later proved necessary to fulfill the subcontract. That title was intended to pass to Curtis to the materials in place is definitely demonstrated when Curtis was allowed to remove the sand and gravel and pay for it thirty (30) days after removal based on his own measurements, subject to check by petitioners. If title was not intended to be vested in Curtis from date of the contract, (Ex. No. 6F), petitioners would have either reserved title by express provision of the contract, or provided for payment before removal. This strong factor in the fact equation was erroneously ignored by the Tax Court, we submit, with full respect.

The Tax Court also erred, we believe, in its statement:

> ". . . the parties did not intend that all or a specified portion of the sand and gravel would be transferred at the date of the contract. The parties herein intended that Curtis would remove an unascertained portion which it later required in order to complete its subcontract. This finding is buttressed by the provision of the contract which measured its duration not in terms of ample time to remove all the sand and gravel but rather in terms of the requirements of the subcontract." (R. 97)

This obviously ignores the dominant intention of the parties to sell only the volume of materials measured by the then unknown, but definitely ascertainable requirements of Curtis for performance of the subcontract. It also over-emphasizes the fact that, speculatively, there might, at completion of the subcontract, remain unmined commercially valuable sand and gravel on petitioners' land. It also ignores the equally great possibility that the supply of all commercially valuable sand and gravel was exhausted.

The Tax Court should have found that Curtis had purchased all the materials "required to enable Purchaser to complete its contract . . ." (R. 91), including all unmined materials in place on petitioners' wastelands necessary to fulfill his subcontract at the Dam. When it proved he did not need all, it would seem immaterial whether any unmined materials of commercial value remained unused by Curtis. What was sold, removed and paid for was reported properly as the sale of a capital asset, subject to capital gains tax treatment on petitioners' returns. It is reasonable to contend petitioners sold all of their commercially

valuable sand and gravel to Curtis; that they estimated with Curtis that Curtis would need all of it to perform his subcontract; that if there was any left on the described land when the contract was performed, it was not commercially valuable either to Curtis or to petitioners. They neither reserved, nor retained any economic interest nor did any "economic interest" "revert" to petitioners. Magical reasoning cannot destroy the facts and circumstances, reasonably interpreted under the law of contracts and under tax law.

If Curtis had breached his contract and refused to remove the commercially valuable sand and gravel suitable for performance of his subcontract with the prime contractor, petitioners had the right to specific performance of that contract. As in **Crowell Land & Mineral Corporation v. Commissioner,** 242 F. (2d) 864 (C.A. 5, 1957), Curtis agreed to pay petitioners a fixed amount over a fixed or ascertainable period of time for a fixed or ascertainable volume of materials removed from a specifically described body of land.

In **Gowans v. Commissioner,** 246 F. (2d) 448 (C.A. 9, 1957) the purchaser was obligated to remove and pay for an ascertainable amount of material and it was held the taxpayer retained no "economic interest". Finally, the Tax Court opinion speaks too generally when it holds: ". . . the parties by their contract intended no more than to set forth the terms at which future transfers to Curtis would be consum-

mated at such times and in such quantity as it required them." (R. 97)

The Respondent stipulated Curtis was obligated to perform his subcontract with the Prime Contractor and to furnish all the sand and gravel for the south portion of the great dam; that borings on petitioners' land about two miles from the damsite showed suitable sand and gravel deposits; that petitioners contracted to sell all of that sand and gravel commercially valuable to Curtis required to perform his subcontract. The parties agreed to be obligated to perform and did perform the contract to the letter as a purchase and sale transaction involving a capital asset. It appears unrealistic and illogical to now say, after performance, that because, perhaps, Curtis did not exhaust all of the materials but only enough to fulfill his subcontract, some imagined "economic interest" either remained with or "reverted" to the taxpayers, thrusting them into large tax deficiencies not anticipated by their accountants or lawyers or themselves.

More than an exclusive right to mine the materials was granted to Curtis by these farmer taxpayers. They sold their sand and gravel in place so he could be enabled to perform his subcontract which required a definitely ascertainable volume of sand and gravel.

THE APPLICABLE CASES

In addition to those cases already cited above, we call this Court's attention to the following cases, some referred to by the Tax Court, some not considered in its Opinion:

In **Burnet v. Harmel,** 287 U.S. 103, 106, the Supreme Court stated the general rule that Congress, governing capital gains taxation, intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions".

Malat v. Riddell, 383 U.S. 569, 16 L. ed. (2d) 102, (Cal. 1966) held that Section 1221 Internal Revenue Code excludes capital assets "property held by taxpayers **primarily** for sale to customers in the ordinary course of business"; that "primarily" means "of first importance or principally" a part of the taxpayers' trade or business.

In **Turner v. United States,** 226 F. Supp. 970 (D. Me., S.D. 1964) a so-called lease was interpreted to be, in substance, a sale of sand and gravel properly taxable at capital gains rates. The Court held that installment payments based upon a fixed price per cubic yard were not, in effect, royalty payments or rentals carved out of the purchaser's resale price or profit. The Maine District Court quoted from **Laudenslager v. Commissioner,** 305 F (2d) 686 (C.A. 3, 1962), a case heavily relied upon by the Tax Court:

> "The owner has retained an economic interest if he has acquired by investment, any interest in the natural deposit in place, and has secured by any form of legal relationship, income derived from the extraction of the deposit, to which he must look for a return of his capital." (Citing **Palmer v. Bender,** 287 U.S. 551, 77 L. ed. 489 (1933) and

Gowans v. Commissioner, 246 F. (2d) 448 (C. A. 9, 1957).

In **Turner,** the court relied upon **Linehan v. Commissioner,** 297 F (2d) 276 (C. A. 1, 1961), and **Crowell Land & Mineral Corporation v. Commissioner,** 242 F. (2d) 864 (C. A. 5, 1957). The Court distinguished **Laudenslager, supra,** and **Albritton v. Commissioner,** 248 F. (2d) 49 (C.A. 5, 1957) because in **Albritton** payment for excavated sand and gravel was based upon a percentage of the retail sales price—not upon a fixed rate per cubic yard, indicating the seller in **Albritton** reserved an "economic interest" in the sand and gravel sold while in **Turner** the unit price per cubic yard was the purchase price and not rent or a royalty payment.

In **United States v. White,** 311 F. (2d) 399, 403 (C. A. 10, 1962), followed in **White v. United States,** 254 F. Supp. 894, 896, (D. C. Colo. 1966) the test was applied to a document referred to as a lease as in **Turner.** The Tenth Circuit, one of the chief mining areas of the Nation, held that substance and not form governs such a transaction; that the dominant purpose of the so-called lease was "in substance a sale rather than a reservation"; that where the purchaser had the right to remove the material or not, as he saw fit, "the economic interest principle advanced by the United States is wholly a legal fiction."

In **Brown v. United States,** (E. D. Ark. 1965), 66-1 U.S.T.C. 9153, the **Turner Case** was approved. The Court held when a farmer sold soil and materials from his farm for highway construction, "the weight of authority" allowed capital gains tax treatment to such

a transaction. A "sale" such as was made by petitioners to Curtis should be given its ordinary meaning in the non-tax world as the term is in no manner limited by the Code.

Commissioner v. Brown, 380 U.S. 563, 14 L. ed. (2d) 75, 82.

Bel v. United States, (D.C. La. 1958), 160 F. Supp. 360.

The First Circuit in **Linehan v. Commissioner,** supra presents a careful analysis of the sand and gravel sale cases, stating:

> "Turning then to the 'true substance' of the transactions between this taxpayer and those to whom he gave the right to remove sand and gravel from his property, it is evident that the taxpayer had no 'economic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."

Judge Medina, for the Second Circuit, in **Barker v. Commissioner,** (C. A. 2), 250 F. (2d) 195, reversed the Tax Court in a sand and gravel tax case and allowed capital gains tax treatment on long term sales amounting, in **all,** to about $190,000.00. The Second Circuit relied in part on the **Crowell** and **Gowans** cases from the Fifth and Ninth Circuits. See 250 F. (2d) at 198. The **Barker** case is important as it holds where title passes to the purchaser, there can be no basis for depletion allowance without an actual reservation of an economic interest in the sand and gravel contracted

to be sold and removed, 250 F. (2d) at 198. **Linehan v. Commissioner**, 297 F. (2d) 276 (C. A. 1)

The Commissioner stipulated that Curtis, under terms of the contract had "the right to remove all the commercially valuable sand and gravel on said lands of petitioners . . ." to fulfill the subcontract. (R. 42, Ex. 6F) That should, we assert, be enough to indicate that no reservation of economic interest was present or intended to exist by the parties.

> "It is evident that the taxpayer had no 'economic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."
>
> **Remer v. Commissioner**, (C. A. 8, 1958), 260 F. (2d) 337

THE MINERAL LEASE, ROYALTY AND LICENSE AGREEMENT CASES ARE NOT APPLICABLE

After the Tax Court opinion was filed, the Supreme Court of the United States denied certiorari on December 4, 1967, in five hard mineral cases. All five cases involved leases or royalty or license agreements for removal of materials. See **Peeler v. United States**, 377 F. (2d) 531 (CA 5, 1967); **Wood v. United States**, 377 F. 2d 300 (CA 5, 1967); **Royalton Stone Corp. v. Commissioner**, 67-2 U.S.T.C. Par. 9519, Docket Nos. 31056-62, 6/14/67 aff'd. Tax Court, C.C.H. Dec. 27, 964 [M], 25 TCM 570, T.C. Memo. 1966-109 (C.A.2, 1967); **Green v. United States**, 377 F. 2d 550 (C.A. 5, 1967); **Commissioner v. Royalton Stone Corp.**

The **Peeler, Wood** and **Green** cases were in the Fifth Circuit. The two **Royalton Stone Corporation** cases came from the Second Circuit.

The Fifth Circuit decided the **Peeler, Wood** and **Green** cases together on May 11, 1967. **Wood's** case involved a "Sand, Gravel and Rock Lease" of lands of the taxpayers.

The lessees were large scale sand and gravel operators who desired to exploit the taxpayers' sand and gravel deposits over a long, indefinite term, with annual minimum "royalty" payments of $15,000.00 plus additional "royalty" payments at 25-cents per cubic yard. **Wood** filed income tax returns claiming depletion allowances, later filing amended returns, claiming refunds of taxes paid on an ordinary income tax basis.

The Fifth Circuit upheld a District Court decision denying recovery by the taxpayers, stating (377 F. (2d) 300 at 305):

> "Clearly, where a 'typical' mineral lease is entered into by a landowner, there is a retention of an economic interest in the minerals. In any case, therefore, an inquiry into the presence of such an interest need go no further unless it can be shown that some characteristics of the agreement make it atypical."

We submit the Hair cases, now here in the Ninth Circuit for review, were clearly "atypical" as the Hairs neither retained, reserved nor provided for re-

verter of any economic interest in the sand and gravel sold and removed under a contract of sale. The contract (Ex. 6F) was not a lease or royalty agreement.

Both the petitioners and Curtis obligated themselves to perform the contract of sale for a specified amount of materials for a specified price, a specified purpose and performance within a specified time.

Following **Wood,** the Fifth Circuit in **Peeler** and **Green** pointed out that both those cases likewise involved leases, not contracts of sale; that mineral leases or royalty and license agreements for removal of sand and gravel, or hard minerals, involve reservation or retention of "economic interest" by the lessor **per se.**

The **Peeler** and **Green** cases were mere per curiam opinions, following **Wood.**

Peeler v. United States, 377 F. (2d) 531 (C. A. 5, 1967)

Green v. United States, 377 F. (2d) 550 (C.A. 5, 1967)

The **Peeler** lease was to run for 20 years and called for minimum yearly royalty and specified additional royalties at a fixed rate per ton — clearly not a contract of sale but a "typical mineral lease" as in **Wood.**

In **Green,** the mineral "lease contract" called for exploitation by a rock products company of lime rock deposits on the lands of the taxpayer for a ten year term, subject to renewal for a second term of ten

years, with minimum annual royalty and additional royalties at a fixed rate per ton of material removed.

The **Wood, Peeler** and **Green** cases, all mineral lease or royalty agreement cases, clearly indicate retention of "economic interest" by the landlord — taxpayers.

The Hair cases now before this Court involved a contract of sale, carefully drawn to sell a specified capital asset — sand and gravel — for a specified price to be paid following removal with performance within the time required by Curtis to perform his subcontract at Lower Monumental Dam.

Likewise the two **Royalton Stone Corporation** cases from the Second Circuit, supra, were true mineral lease or royalty cases irrefutably connoting retention of "economic interest" by the landowner under the rationale of **Wood's** case in the Fifth Circuit. **Royalton Stone Corporation v. Commissioner,** supra, **Commissioner v. Royalton Stone Corporation,** supra.

The lessee in those cases was not under duty to mine at all and actually was only a mere licensee.

The Second Circuit distinguished the **Royalton Stone Corporation** cases from **Crowell Land and Mineral Corporation v. Commissioner,** 242 F. (2d) 864 (C. A. 5, 1957) and **Barker v. Commissioner,** 250 F. (2d) 195 (C. A. 2, 1957) and from **Gowans v. Commissioner,** 246 F. (2d) 448 (C. A. 9, 1957) and followed the rationale of the mineral lease-royalty-license cases, particularly **Wood v. United States,** 377 F. (2d) 300 (C.A. 5, 1967).

The **Wood** case opinion also distinguished the **Linehan, Barker, Gowans, White** and **Crowell Land and Mineral Corporation** cases.

The **Crowell** case is from the Fifth Circuit and it was not overruled in **Wood's** case.

Commenting upon **Gowans,** the case in the Ninth Circuit relied upon by petitioners in the Tax Court, the Fifth Circuit in the **Wood's** decision said:

> ". . . The court further (in **Gowans**) noted that under the agreement the buyer was obligated to remove all of the sand and that the quantity of the sand had been determined 'with great accuracy' prior to execution of the agreement. The court also felt that the execution of a bank note as security for the buyer's performance gave the seller a source other than production from which to obtain his compensation under the contract. Viewing all the above circumstances, the court held that taxpayer had not retained an 'economic interest' in the sand . . ."
>
> **Wood v. Commissioner,** 377 F. (2d) 300 (C. A. 5, 1967), cert. den. December 4, 1967, No. 475, ...

Like **Gowans,** petitioners' cases are based upon a true contract of sale between sellers and purchaser of sand and gravel in quantity determined "with great accuracy" by borings before the contract was performed. (R. 42) We must emphasize that petitioners were farmers and not exploiters of sand and gravel deposits on their land and Curtis was a contractor, not engaged in the purchase and sale of sand and gravel for resale, but engaged in dam construction under definite contract. (R. 42, 45)

CONCLUSION

> "A bona fide sale was the intent of the parties and it was expressed in terms free from ambiguity throughout the instrument in the provisions and conditions it set out. Looking to the actual circumstances as well as the language of the contract of sale, there is no occasion or basis for resorting to legal niceties of interpretation to defeat the basic purpose and effect of the transaction." **Wood v. Commissioner**, 377 F. (2d) 300 (C. A. 5, 1967)

"Economic interest" cannot be proved by speculation when a seller attempts in good faith to sell sand and gravel as a capital asset to secure the benefit of Section 1221 of the Internal Revenue Code. See **Malat v. Riddell**, 383 U.S. 569 (Cal. 1966) 16 L. ed. (2d) 102.

Petitioners were not dealers in the sale of sand and gravel and they effected a genuine sale "of all usable sand and gravel in place, within specified areas and at specified cubic yard prices," with quantity "determined with great accuracy" as measured by the amount needed by Curtis for performance of his subcontract on the Snake River project. See, **Dann v. Commissioner**, 30 T.C. 499 (1958), reversed in **Linehan v. Commissioner**, 297 F. (2d) 276 (C. A. 1, 1961)

The Tax Court confused the instant cases with mineral lease, royalty and license cases and refused to follow the weight of sound authority symbolized by the **Gowans, Barker, Remer, Linehan, White** and **Crowell Land and Mineral Corporation** cases, supra.

The parties intended title to pass and it did pass to all sand and gravel necessary to complete the purchaser's subcontract. The Tax Court decision should be reversed.

Respectfully submitted,

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APPENDIX OF EXHIBITS REFERRED TO HEREIN

All of the exhibits were stipulated to be Joint Exhibits of Petitioners and Respondent. (R. 40-48)

Exhibit No.	Description	Stipulated Into Record
1A	1962 Return, Melvin Hair et ux	R. 41, 49-56
2B	1963 Return, Melvin Hair et ux	R. 41, 57-65
3C	1962 Return, Richard Hair et ux	R. 41, 67-73
4D	1963 Return, Richard Hair et ux	R. 41, 74-82
5E	Map describing land of Petitioners from which sand and gravel was sold and removed	R. 41, 83
6F	Contract dated April 11, 1962, between Petitioners and Curtis Construction Company	R. 42, 84-87

APPENDIX OF JOINT EXHIBITS REFERRED TO IN THIS BRIEF

CERTIFICATE OF COUNSEL

Cameron Sherwood, one of attorneys for Petitioners, states:

I certify that, in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with these Rules.

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